[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOL) BETWEEN THE UNITED STATES AND THE PEOPLE'S REPUBLIC OF CHINA

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON JULY 30, 1985

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JULY 29, 1985

U.S. GOVERNMENT PRINTING OFFICE
50-465 O WASHINGTON : 1985 JCS-28-85

J862-34
S382-16

CONTENTS

Page

INTRODUCTION 1

I. SUMMARY 2

II. ISSUES 10

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND TAX TREATIES 19

A. United States Tax Rules 19
B. United States Tax Treaties—In General 21

IV. EXPLANATION OF PROPOSED TAX TREATY 24

Article 1. (Residence) 24
Article 2. (Taxes covered) 24
Article 3. (General definitions) 25
Article 4. (Fiscal residence) 27
Article 5. (Permanent establishment) 28
Article 6. (Income from real property) 30
Article 7. (Business profits) 31
Article 8. (Related persons) 33
Article 9. (Dividends) 34
Article 10. (Interest) 35
Article 11. (Royalties) 37
Article 12. (Gains) 38
Article 13. (Independent personal services) 39
Article 14. (Dependent personal services) 40
Article 15. (Directors' fees) 40
Article 16. (Entertainers and athletes) 40
Article 17. (Pensions) 41
Article 18. (Government service) 42
Article 19. (Teachers and researchers) 43
Article 20. (Students, apprentices, and trainees) 43
Article 21. (Other income) 44
Article 22. (Relief from double taxation) 44
Article 23. (Nondiscrimination) 46
Article 24. (Mutual agreement procedure) 47
Article 25. (Exchange of information) 49
Article 26. (Diplomatic agents and consular officers) 50
Article 27. (Entry into force) 50
Article 28. (Termination) 50
Proposed Protocol 51
Exchange of Notes 53

INTRODUCTION

This pamphlet[1] provides an explanation of the proposed income tax treaty, as modified by the proposed protocol, between the United States and the People's Republic of China. The proposed treaty and protocol were both signed on April 30, 1984. The proposed treaty was amplified by an exchange of notes signed the same day. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty and protocol on July 30, 1985.

The proposed treaty is the first comprehensive income tax treaty between the United States and the People's Republic of China. An agreement between the two countries governing the taxation of shipping and aircraft income only was signed on March 5, 1982, and is currently in force.[2] The proposed treaty does not alter the tax rules for shipping and aircraft income set forth in that prior agreement.

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model treaty"), and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model treaty"). However, there are certain deviations from those documents. In addition, a number of the proposed treaty's provisions follow the United Nations model income tax treaty between developed and developing countries ("United Nations model treaty").

The first part of the pamphlet summarizes the principal provisions of the proposed treaty. The second part presents a discussion of the issues that the proposed treaty raises. The third part provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in part four by a detailed explanation of the proposed treaty and protocol.

---

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty (and Proposed Protocol) between the United States and the People's Republic of China (JCS-28-85), July 29, 1985.*

[2] For a description of the agreement between the United States and the People's Republic of China governing the taxation of shipping and aircraft income, *see* Senate Comm. on Foreign Relations, Report on Treaty Doc. 97-24, S. Exec. Rep. No. 14, 98th Cong., 1st Sess. (1983).

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and the People's Republic of China ("China") are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty provides that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 13). Similarly, the treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 13, 14, and 16). The proposed treaty provides that dividends, interest, royalties, capital gains, and certain other income derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 9, 10, 11, and 12). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 9, 10, and 11).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit.

Like other U.S. tax treaties, the proposed protocol contains a "saving clause". Under this provision, the United States retains the right to tax its citizens and residents as if the treaty had not come into effect. In addition, the protocol contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries; that is, the treaty will only be applied to the benefit of taxpayers.

Differences in proposed treaty and model treaties

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model treaty. Some of these differences are as follows:

(1) At China's request, the proposed treaty has been designated an "agreement." Generally, tax treaties rendered in English are designated "conventions." This difference in terminology does not have any substantive significance.

(2) U.S. citizens who are not also U.S. residents are not generally covered by the treaty. The U.S. model does cover such U.S. citizens. However, the United States has rarely been able to negotiate coverage for nonresident citizens.

(3) Under the proposed treaty, the competent authorities of the United States and China are, through consultations, to determine a single residence for a company that is a resident of both countries under local law. The treaty does not specify criteria for the competent authorities to follow in making the determination. If the competent authorities are unable to determine a single residence, the company will not be considered a resident of either country and, thus, will be ineligible for treaty benefits. In addition, a company that is both a U.S. resident, under U.S. law, and a third-country resident, under a tax agreement between a third-country and China (because, for example, the company is considered to be managed in the third-country), will not be considered a U.S. resident for purposes of enjoying the benefits of the proposed treaty. The U.S. model treaty contains different rules for dual resident corporations. Under the U.S. model, a corporation that is a resident of both the United States and its treaty partner under local law is automatically considered a resident of the country under whose laws it was first created and is thus entitled to the same treaty benefits that other corporate residents of that country receive. Further, a U.S.-incorporated company that is a resident of another treaty partner of the United States' treaty partner is not denied U.S. treaty benefits.

The first of the proposed treaty's two dual corporate resident rules technically permits determinations of a single corporate residence that would be inconsistent with the U.S. tax policy of not restricting, by treaty, U.S. taxation of U.S. corporations. The competent authorities of the two countries are free, for example, to decide that a company incorporated in the United States and, therefore, resident in the United States under U.S. law, and resident in China under Chinese law should be treated as a Chinese resident for treaty purposes. In the event of such a determination, the United States would be obligated to extend treaty reductions in *U.S.* tax to the U.S.-incorporated company. Such a determination would also deprive the U.S. corporation of the treaty reductions in *Chinese* tax otherwise available to U.S. corporations. Staff is informed, however, that the U.S. competent authority has never agreed to treat a U.S.-incorporated company as a resident of another country under existing treaties, and does not intend to agree to such treatment in the future.

The first dual corporate resident rule also might result in the denial of treaty benefits to a company resident in both China and the United States under local law. It might tend to encourage such a company to establish a single residence in one of the countries in order to ensure treaty coverage.

The second dual corporate resident rule does not appear in any existing U.S. income tax treaty. It may complicate the planning of U.S. multinationals in certain cases. For example, it is possible that a U.S. corporation operating in China might inadvertently lose its benefits under the proposed treaty if it opens a branch in a third country where it is then treated as a resident under a treaty between that country and China. The rule might encourage a U.S. corporation considered to be managed in and, therefore, a resident of another Chinese treaty partner to establish a single residence in the United States in cases where the benefits provided to the U.S. corporation under the third-country treaty with China fall short of the benefits available to U.S. corporate residents under the proposed treaty.

(4) The proposed treaty does not have an article governing the taxation of shipping and aircraft income. Rules for shipping and aircraft income are provided in a separate shipping and aircraft income tax agreement between the two countries signed on March 5, 1982, and currently in force.

(5) The definition of a permanent establishment in the proposed treaty is somewhat broader than that in the U.S. model and in many existing U.S. treaties. The principal areas in which the proposed treaty departs from the U.S. model are the inclusion as a permanent establishment of a building site or construction, assembly, or installation project that continues for more than six months, and the inclusion as a permanent establishment of an installation, drilling rig, or ship that is used for more than three months for the exploration or exploitation of natural resources (rather than, in each case, the U.S. model's 12 months). In addition, engaging in supervisory activities in connection with building sites, etc. for more than six months, or furnishing services, including consultancy services, through personnel engaged for that purpose, for more than six months in any twelve-month period (even without a fixed place of business), would create permanent establishment status under the proposed treaty but not under the U.S. model. An independent agent of an enterprise will constitute a permanent establishment under the proposed treaty if the agent's activities are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's-length conditions; the U.S. model does not contain this rule though a few U.S. tax treaties with developing countries do.

(6) The proposed treaty differs from the U.S. model in not providing investors in real property in the country not of their residence with an election to be taxed on such investments on a net basis. However, current U.S. law provides foreign persons with such an election.

(7) The proposed treaty does not contain a definition of "business profits," although certain categories of business profits are defined in various articles. This leaves to local law the definition of that term in some cases. Business profits must be attributed to a perma-

nent establishment before they can be taxed by the country where the permanent establishment is located.

Many U.S. treaties, and the U.S. model, define business profits to include income from rental of tangible personal property and income from rental or licensing of films or tapes. The absence of such an inclusion in the proposed treaty means that persons who earn such rental or licensing income could be subject to tax in the source country on a gross basis rather than on a net basis unless they maintain a permanent establishment there.

(8) The proposed treaty contains rules not found in the U.S. model treaty limiting deductions in computing taxable business profits of a permanent establishment. For example, the proposed treaty disallows any deduction for interest paid (other than in reimbursement of actual expenses) by a permanent establishment to its head office on money lent to the permanent establishment. These rules are patterned after rules contained in the United Nations model treaty; however, the United Nations model exempts branch banks from the prohibition on the deduction of interest paid to a permanent establishment's head office. Rules similar to those of the proposed treaty are included in certain other U.S. income tax treaties with developing countries.

The proposed treaty also provides that a country may determine profits attributable to a permanent establishment on a deemed basis if, under its internal law, it does so with respect to other entities in that permanent establishment's industry and if the result is in accordance with the principles contained in the business profits article. Recent U.S. income tax treaties and the U.S. model treaty do not contain this provision. Staff is informed that it is generally China's practice to deem as taxable profits 10 percent of the Chinese source gross receipts of U.S. subcontractors from offshore oil operations. Staff is further informed that China deems as taxable profits 10 percent of the Chinese source gross receipts with respect to outgoing traffic received by operators of ships and aircraft in international traffic. In both cases, a 50-percent tax is imposed on the deemed profits. However, under the agreement currently in force between the United States and China governing the taxation of shipping and aircraft income, income earned by a U.S. enterprise from the operation of ships or aircraft in international traffic is exempt from Chinese tax.

(9) The limit on the gross dividend tax that the country of source may impose is 10 percent, in contrast with the five percent limit for direct dividends and 15 percent limit for portfolio dividends in the U.S. model.

(10) The U.S. model treaty allows one country to tax dividends paid by a resident company of the other country from profits of its permanent establishment in the first country constituting 50 percent or more of the company's worldwide income. The proposed treaty allows one country to tax dividends paid by a resident company of the other only when the dividends are (a) paid to a resident of the first country or (b) with respect to a stock holding or other corporate right effectively connected with a permanent establishment or a fixed base in the first country. This variation from the U.S. model has the effect of prohibiting the United States from imposing its "second tier" withholding tax on dividends (see Code sec.

861(a)(2)(B)) paid by any Chinese company that in the future earns significant business profits in the United States. The proposed treaty, unlike the U.S. model, also expressly prohibits a country from taxing the undistributed profits of a company resident in the other country.

(11) The proposed protocol prohibits the United States from imposing its personal holding company and accumulated earnings taxes on Chinese companies that are wholly owned by either the Chinese government or individual residents of China (who are not U.S. citizens). The personal holding company and accumulated earnings taxes are not covered taxes under the U.S. model treaty and, thus, their imposition is not limited by the model.

(12) The proposed treaty generally limits the tax at source on gross interest to 10 percent; interest derived by the governments of the countries, by certain government financial institutions, and by individuals on debt-claims indirectly financed by the foregoing entities is exempt from source country tax. Under the U.S. model, all interest, by contrast, generally is exempt from source country withholding tax. The U.S. model position is rarely achieved.

Because of the recent repeal (in the Tax Reform Act of 1984) of the U.S. gross withholding tax on interest paid on portfolio indebtedness held by foreign persons, Chinese residents generally will receive U.S. source interest on portfolio indebtedness free of U.S. tax in any event. However, U.S. residents generally will be subject to Chinese tax (limited to 10 percent by the treaty) on Chinese source interest on similar indebtedness, subject to certain exemptions.

(13) The proposed treaty generally limits the tax at source on gross royalties, including movie royalties, to 10 percent. In the case of royalties paid for the rental of industrial, commercial, or scientific equipment, the proposed protocol further reduces the maximum rate to seven percent. The U.S. model exempts royalties from source country tax.

(14) The proposed treaty limitations on source country withholding tax on dividends, interest, and royalties paid to residents of the other country apply, by their terms, only if the recipient of the income is also its beneficial owner. Under the U.S. model treaty, by contrast, these limitations on source country withholding tax generally apply so long as the beneficial owner of the income resides in the nonsource country; in that case, initial receipt of the income by an intermediary that is not the beneficial owner is irrelevant.

The proposed treaty language is similar to that of the OECD model treaty. Read literally, the proposed treaty language permits interest, for example, received from sources in one country by a nominee for the interest's beneficial owner to be taxed fully by the source country even though the beneficial owner resides in the other treaty country. The commentaries on the OECD model indicate, however, that this language should not be interpreted to deny the reduced source country withholding tax rates to dividend, interest, or royalty payments received by a nominee or other agent of the beneficial owner when the beneficial owner is a resident of the nonsource country. Staff is informed by the Treasury Department that the countries intend the language to be interpreted consistent with the OECD commentaries.

(15) The proposed treaty allows source country taxation of most capital gains, including gains on the disposition of real estate. The treaty's rules preserve U.S. tax under the Foreign Investment in Real Property Tax Act of 1980. The U.S. model generally permits source country taxation of real estate gains and gains from the alienation of personal property attributable to a permanent establishment or fixed base in the source country, but prohibits other source country taxation of capital gains.

(16) The proposed treaty allows source country taxation of independent professional services income on the basis of presence in the source country for more than 183 days in a calendar year. The U.S. model treaty does not allow taxation of such income on the basis of days of presence. Under the U.S. model, independent personal services income of a nonresident is taxable only if the nonresident has available a fixed base in the source country.

(17) The proposed treaty allows directors' fees derived by a resident of one country in his capacity as a member of the board of directors of a company which is a resident of the other country to be taxed in that other country. The U.S. model treaty, on the other hand, treats directors' fees as personal service income or as a distribution of profits. Under the U.S. model treaty (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income and the source country tax on distributed profits is limited.

(18) Under the proposed treaty, source country taxation of income derived by entertainers and athletes from their activities as such is not permitted if the income is derived in accordance with a special program for cultural exchange agreed upon by the U.S. and Chinese Governments. Staff is informed that U.S. entertainers and athletes presently perform in China (and Chinese entertainers and athletes presently perform in the United States) only in accordance with such special programs. Under the U.S. model treaty, entertainers and athletes may not be taxed in the source country unless they earn more than $20,000 there during a taxable year. Most U.S. income tax treaties follow the U.S. model approach, with a lower annual income threshold for taxation than the U.S. model contains.

(19) The proposed treaty does not limit taxation of annuities, alimony, or child support payments. The U.S. model treaty allows taxation of annuities and alimony payments only in the country of residence of the recipient, and taxation of child support payments only in the country of residence of the payor.

(20) Under the proposed treaty, the salaries of visiting teachers and researchers are exempt from tax in the source country for three years. Under the U.S. model, these salaries are subject to the standard rules, ordinarily resulting in full source country taxation. A number of existing U.S. income tax treaties provide visiting teachers and researchers with a two-year exemption from source country taxation.

(21) The exemption from source country taxation provided to visiting students and trainees is broader than that provided in the U.S. model. The U.S. model exemption applies only to payments received from outside the source country for maintenance, education, study, research, or training. The proposed treaty exemption ex-

tends to, among other things, grants and awards from governmental and other tax-exempt organizations and $5,000 per year of personal services income. The proposed treaty exemption is similar to that incorporated in some other U.S. income tax treaties with developing countries; it differs, however, from the exemptions provided in those treaties in not terminating after a fixed number of years (typically five).

(22) The proposed treaty allows the source country to tax any income not otherwise specifically dealt with under under the treaty. The U.S. model treaty, by contrast, gives the residence country the sole right to tax income not otherwise specifically dealt with under the treaty, unless the income is attributable to a permanent establishment or a fixed base in the other country. The rule of the proposed treaty is contained in a number of existing U.S. income tax treaties.

(23) The proposed treaty's nondiscrimination provision differs from the U.S. model treaty's in protecting all legal persons deriving their status as such from the United States, not U.S. citizens alone. The rule of the proposed treaty is contained in a number of existing U.S. income tax treaties.

(24) The proposed treaty's exchange of information provision generally follows that of the U.S. model, but is somewhat narrower in scope. The U.S. model treaty provides for the exchange of information relating to taxes of every kind imposed by the two countries. The proposed treaty provides for the exchange of information relating only to taxes it covers. The U.S. model treaty requires that, upon an appropriate request for information, the requested country obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. It also requires that, where specifically requested by the competent authority of one country, the competent authority of the other country provide the information in the form requested. The proposed treaty does not include these requirements. In addition, the U.S. model treaty provides that each country will collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. The proposed treaty does not contain this collection rule.

The proposed treaty, like the U.S. model, makes it clear that the appropriate Congressional committees and the General Accounting Office are to have access to information exchanged under the treaty where appropriate.

(25) The "saving clause" (added by the proposed protocol) differs in certain respects from that found in the U.S. model treaty and those found in most recent U.S. income tax treaties. The principal differences are: Under the U.S. model treaty, both countries generally reserve the right to tax their citizens and residents as if the treaty had not come into effect; under the proposed protocol, only the United States does. Under the U.S. model treaty, there are several exceptions to this reservation of taxing rights; under the proposed protocol, the United States reserves the right to tax its citizens without exception. The U.S. model contains a provision specifically retaining a country's right to tax former citizens who renounced citizenship to avoid income tax; the proposed treaty does not. Even absent such a provision, however, the Internal Revenue

Service takes the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).

(26) The proposed treaty's anti-treaty shopping provision (added by the proposed protocol) is considerably less comprehensive than that of the U.S. model treaty and most recent U.S. income tax treaties. (See discussion under "Issues" below.)

(27) In notes exchanged at the signing of the proposed treaty and protocol, the United States and China agreed that a tax sparing credit would not be provided at the present time. However, the countries agreed that the proposed treaty would be promptly amended to incorporate a tax sparing credit provision if, in the future, the United States amended its laws concerning the provision of tax sparing credits, or the United States reached agreement on the provision of a tax sparing credit with any other country. This agreement is similar to, but goes somewhat beyond, existing agreements between the United States and certain developing countries regarding the reduction of conflicts between the U.S. tax system and the developing country's foreign investment tax incentives. The existing agreements do not refer explicitly to a tax sparing credit and do not include a promise by the United States to allow such a credit upon allowing it to any other country, i.e., they do not confer most favored nation status on the U.S. treaty partner in connection with the tax sparing credit. Generally, the existing agreements commit the United States only to resume discussions, when circumstances permit, with a view to incorporating provisions in the treaty that will minimize interference with incentives offered by the other country and be consistent with U.S. income tax policy vis a vis other developing countries. Any future amendment of the proposed treaty to provide a tax sparing credit, like any treaty amendment, would be subject to the full negotiation and Senate ratification processes that apply to treaties generally.

(28) Income derived by a resident of one country that may be taxed in the other country under the proposed treaty is deemed to arise in that other country for purposes of the proposed treaty. However, the proposed treaty omits the U.S. model provision stating that this source rule does not apply in determining foreign tax credits for foreign taxes paid by U.S. residents to third countries.

II. ISSUES

The proposed treaty and protocol raise the following specific issues:

(1) Covered Chinese taxes

The treaty covers four Chinese taxes: the individual income tax, the income tax concerning joint ventures with Chinese and foreign investment, the income tax concerning foreign enterprises, and the local income tax. All of these taxes are new, adopted in 1980 or later. Staff understands that, in general, the covered Chinese taxes are presently collected chiefly from foreigners. The income tax concerning foreign enterprises and local income tax imposed under the same statute apply by their terms to foreign enterprises only. While Chinese individuals, like foreign individuals, technically are subject to the individual income tax, staff understands that few Chinese presently earn enough to incur any tax liability. Only the joint venture income tax appears to apply evenly to Chinese and foreign investment.

In drafting the covered taxes, the Chinese Government apparently sought to make them creditable under the internal creditability rules of the United States and certain other Chinese trading partners, i.e., in the absence of any special treaty credit rules. In private letter rulings, the Internal Revenue Service has held that, under certain circumstances, three of the four covered taxes are creditable for U.S. tax purposes;[3] it has not ruled on the creditability of the income tax concerning joint ventures. The favorable rulings were issued under temporary regulations that have since been finalized in modified form. Although the matter is not entirely free from doubt, the taxes previously ruled on, as well as the net income tax imposed under the joint venture income tax law, are probably creditable generally under the final regulations. The 10-percent withholding tax imposed under the joint venture income tax law appears to be creditable too under the regulations.[4]

If the covered Chinese taxes are fully creditable under U.S. internal law, then, even in the absence of the treaty, they generally reduce on a dollar-for-dollar basis the U.S. tax otherwise due on the foreign income of a U.S. taxpayer who pays them. U.S. tax revenues are reduced accordingly. Thus, the structuring of the Chinese taxes to meet the creditability requirements of the United States and other Chinese trading partners, while understandable from China's point of view, may result in an effective transfer of tax revenue from the U.S. to the Chinese Treasury, even in the absence of any special treaty credit rules. The amount of that transfer, it should be noted, is limited by a variety of factors, including the relatively low rates of Chinese tax presently applicable, the possibility of excess foreign tax credits from operations in third countries that would shelter Chinese source income from U.S. tax in the absence of the Chinese taxes, and the relatively limited level of U.S. earnings in China at present.

---

[3] *See* LTRS 8352099, 8326084 & 8238037.

[4] However, it should be noted that a technical question regarding the creditability of the withholding tax has been raised. *See* D. Foster & J. Horsley, ***Business Operations in the People's Republic of China*** (BNA Tax Management Foreign Income Portfolios) A-26 -A-27 (1983).

Nonetheless, the United States could, if it thought it desirable, amend its internal creditability rules in a manner that might discourage foreign governments from establishing taxes collected chiefly from nonresidents that effectively transfer tax revenue from the U.S. Treasury to the foreign government's treasury. While Congress might be willing to override treaties to achieve this goal, the presence of treaty credit rules (in the proposed treaty and other U.S. income tax treaties) may complicate any future Congressional efforts to restrict the indirect transfer of U.S. tax revenues to foreign governments via the foreign tax credit mechanism. For example, the Treasury Department, China, and other affected U.S. treaty partners might object to a future statutory override of treaty rules. This raises the issue of whether the U.S. foreign tax credit should be specifically provided by treaty with respect to foreign taxes established chiefly for imposition on nonresidents. The larger issue (which arises independent of the treaty) is whether foreign taxes collected primarily from nonresidents that have been structured by foreign governments to meet U.S. creditability requirements should be creditable under U.S. internal law.

As to the first issue, most existing U.S. income tax treaties, like the proposed treaty, do specifically allow the crediting of covered foreign taxes. The U.S. model treaty imposes a per country limitation on the credit for taxes deemed creditable solely by virtue of the treaty. The proposed treaty, like many U.S. income tax treaties, does not impose a per country limitation. In general, a per country limitation may reduce the amount of the credit and, thus, the amount of U.S. revenue loss, when the treaty partner's taxes are relatively high. However, as indicated above, the covered Chinese taxes are probably creditable independent of the treaty.

As to the second issue, statutory or regulatory limitations on the creditability of foreign taxes structured to meet U.S. creditability requirements would raise some significant policy concerns. First, many or most new taxes instituted by capital-importing foreign countries probably are structured with creditability in mind; it may be unreasonable for the United States to argue that foreign countries should not structure new taxes to make them creditable. Second, such statutory or regulatory limitations might encourage foreign countries to substitute noncreditable taxes other than net income taxes for creditable net income taxes; noncreditable taxes could result in the double taxation of foreign earnings of U.S. taxpayers. Third, the intent of foreign tax officials in structuring a tax in a particular manner could be very difficult to determine. A foreign country is likely to protest if a tax it has newly adopted is treated as noncreditable while a similar tax adopted by another country before the creditability limitations were imposed remains creditable; application of the creditability limitations to taxes predating those limitations would solve this political problem but would potentially require the Internal Revenue Service to determine the intent of foreign drafters five, ten, or more years after the drafting of the tax rules in question.

The creditability rules might be amended simply to deny a credit for taxes collected chiefly from foreigners; i.e., an inquiry into the intent of the drafters could be avoided. There are potential problems with this approach too however. For example, establishing criteria for determining whether a tax is collected "chiefly" from foreigners, and determining as an empirical matter whether those criteria are satisfied could prove difficult. Further, it would probably be necessary to distinguish foreign taxes collected chiefly from foreigners, such as source country withholding taxes on passive income—which substitute for similar taxes collected from *domestic* taxpayers—from foreign taxes collected chiefly from foreigners with respect to which there are no corresponding domestic taxes. Distinguishing the former from the latter could also prove difficult in some cases.

A broader issue that the treaty's coverage of the Chinese taxes raises is whether the United States should ever acquiesce by treaty in the imposition by other countries of taxes on U.S. persons that are collected chiefly from nonresidents. On the one hand, three of the four taxes at issue arguably discriminate against nonresidents. (The exception is the joint venture income tax.) On the other hand, some argue that these taxes do not discriminate because, under China's socialist economic system in its present form, the Chinese Government "owns" most if not all of the earnings of its residents. In any event, assuming the taxes in question did discriminate against nonresidents, the treaty's primary effect with respect to the taxes arguably would be to lessen their discriminatory impact by limiting them in some cases: in the absence of the treaty, China could subject U.S. persons to these taxes without any reductions.

(2) *Developing country concessions*

The proposed treaty contains a number of developing country concessions. Many of these concessions are found in the United Nations model income tax treaty between developed and developing countries and in other U.S. tax treaties with developing countries.

Developing country concessions generally

The proposed treaty departs significantly from the U.S. and OECD model treaties in providing for relatively broad source basis taxation. The proposed treaty's permanent establishment clause, for instance, permits the country in which business activities are carried on to tax the activities sooner, in certain cases, than it would be able to under the U.S. or OECD model treaty. Under the proposed treaty, the use of a drilling rig in a country for more than three months creates a permanent establishment there; under the U.S. model, drilling rigs must be present for at least one year. Thus, under the proposed treaty, business profits attributable to a U.S. drilling rig located in the South China Sea, for example, will be taxable by China if the rig stays there for more than three months. Certain construction activities create a permanent establishment under the proposed treaty if they continue in a country for more than six months, in contrast with the 12-month threshold in the U.S. model. Also, under the proposed treaty, unlike the U.S. model, the performance of certain supervisory services in connection with building sites, etc., or the performance of certain consulting and other services though personnel engaged by an enterprise for that purpose (even if the enterprise has no fixed place of business in the country of performance) can, by itself, create a permanent establishment. The practical effect of these rules could be greater Chinese taxation of U.S. mineral exploration activities, construction activities, and consulting services than would be the case if the model treaty rules were used.

In addition, an independent agent of an enterprise may constitute a permanent establishment of that enterprise under the proposed treaty if the agent's activities are devoted wholly or almost wholly on behalf of that enterprise and it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions. The U.S. model does not contain this rule though a few U.S. treaties with developing countries do.

Other concessions to source basis taxation in the proposed treaty include maximum rates of source country tax on direct dividends, interest, and royalties that, while in line with those provided in some other treaties with developing countries, are higher than those provided in the U.S. model treaty and some U.S. treaties; taxing jurisdiction on the part of the source country as well as the residence country with respect to income not otherwise specifically dealt with by the treaty; and broader source country taxation of independent personal services income, directors' fees, and entertainers' income than that allowed by the U.S. model.

In addition to allowing relatively broad source basis taxation, the proposed treaty contains some other types of developing country concessions. For example, the treaty prohibits the United States from imposing its personal holding company and accumulated earnings taxes on Chinese companies that are wholly owned by either the Chinese Government or individual residents of China (who are not U.S. citizens). In notes exchanged when the treaty was signed, the United States agreed to amend the treaty to provide a U.S. tax sparing credit should the United States agree to the provision of such a credit in a future treaty with any another country.

The issue is whether these developing country concessions are appropriate U.S. treaty policy and, if so, whether China is an appropriate recipient of these concessions. The concessions acknowledge China's status as a capital importing country. Some or all of the concessions are arguably necessary in order to obtain treaties with developing countries such as China. Treaties with developing countries can be in the interest of the United States because they provide tax relief for U.S. investors and a framework within which the taxation of U.S. investors will take place; staff is informed that uncertainty regarding the Chinese taxation of foreign persons has been a significant problem for U.S. investors. On the other hand, there is a risk that the inclusion of these concessions in the proposed treaty could result in additional pressure on the United States to include them in future treaties negotiated with developing countries. However, a number of existing U.S. treaties with developing countries already include similar concessions.

Different permanent establishment rules for drilling and construction activities

As indicated above, the proposed treaty defines a permanent establishment to include a drilling rig used for the exploration or exploitation of natural resources in a country if it is so used for more than three months. This treatment contrasts with the treaty's six-month permanent establishment rule for construction activities. In its 1984 report on the income tax treaty with Canada, the Senate Committee on Foreign Relations expressed its view that the offshore activities of contract drillers are, as a general matter, closely analogous to construction activities.[5] The Committee indicated its strong belief that the permanent establishment threshold for drilling contractors should be the same as that provided for enterprises engaged in construction activities.[6] The proposed treaty once again presents the issue whether unequal treatment for drilling rigs and construction activities is appropriate. On the one hand, it might be argued that the United States should not make concessions of this kind, especially in light of the Committee's comments just over a year ago. On the other hand, the proposed treaty with China was signed before the Committee made the comments described above. Therefore, it may be argued, unequal treatment is appropriate in this case. In addition, it might be argued that this treatment must be viewed in the context of an overall agreement that benefits a broad range of U.S. taxpayers and the United States.

(3) Treaty shopping

The proposed treaty, like a number of U.S. income tax treaties, generally limits source country withholding tax on interest paid to residents of the other country. Although this treaty tax reduction (like other tax reductions and tax exemptions provided in the proposed treaty) is intended to benefit residents of China and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation of interest to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of U.S. tax on interest by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country, which then makes the loan to the U.S. persons and claims the treaty reduction for the interest it receives.

By repealing the U.S. gross withholding tax on interest paid to foreigners on certain portfolio indebtedness, the Tax Reform Act of 1984 limited treaty shopping incentives dramatically. Opportunities for treaty shopping remain, however, where the United States still imposes tax on interest paid to foreigners. The United States taxes interest paid to parties related to the payor, interest on pre-July 19, 1984, debt, and certain interest paid to banks.

---

[5] Tax Convention and Proposed Protocols with Canada, Report of the Senate Committee on Foreign Relations, Exec. Rep. No. 98-22. May 21, 1984, p. 7-8.

[6] *Id.*

The anti-treaty shopping provision of the proposed treaty (added by the proposed protocol) is much less detailed than the anti-treaty shopping provision of the current (1981) U.S. model treaty, and the provisions found in most recent U.S. treaties. It is considerably less strict than the anti-treaty shopping provision of the current U.S model. While the U.S. model provision is only one of several approaches that the Treasury Department considers satisfactory to prevent treaty shopping abuses, the model provision is nonetheless a standard against which to compare the proposed treaty's anti-treaty shopping provision. This raises the issue of whether a stronger anti-treaty shopping provision is necessary to forestall potential treaty shopping abuses.

There are several respects in which the anti-treaty shopping provision of the proposed treaty is more lenient than that of the 1981 U.S. model and other recent U.S. treaties. Under the proposed treaty provision, only treaty benefits provided under the dividend, interest, and royalty articles (chiefly reduced source country withholding tax rates) may be denied; under the U.S. model provision, all treaty benefits may be denied. The proposed treaty provision applies to companies only; the U.S model treaty provision applies to all persons except individuals, that is, all business organizations. The proposed treaty provides that the competent authorities of the two countries "may through consultation deny" treaty benefits. Some have argued that, under this language, if the Chinese competent authority, for example, fails to cooperate, the United States will be unable to prevent third-country residents from obtaining treaty reductions in U.S. tax through the use of an investing entity set up in China. (According to the Treasury Department, however, treaty benefits could be denied under the anti-treaty shopping rules without prior consultations by the competent authorities.) The U.S. model's anti-treaty shopping provision does not contain language referring to consultations by the competent authorities. Further, under the proposed treaty, sanctions against treaty shopping may be imposed only if a company formed in a third country becomes a resident of one of the countries for the principal purpose of enjoying the proposed treaty's benefits; under the U.S. model, sanctions may be imposed, in addition, if the conduct of a company's operations had as its principal purpose obtaining treaty benefits, whether the company was formed in a third country or in one of the treaty countries, and regardless of the original purpose of the company's becoming a resident of one of the treaty countries. In effect, the only treaty shopping that the treaty prohibits is a form of treaty shopping hitherto virtually nonexistent.

The U.S. model applies an additional "safe harbor" test to determine whether, when the requirements for the imposition of sanctions just discussed have been met, treaty benefits actually will be denied. Treaty benefits will be denied to a business organization in such a case unless it is owned 75 percent or more by individuals residing in the country of which it is a resident, and its income is not used in substantial part to meet liabilities to persons residing in third countries who are not U.S. citizens. The proposed treaty does not apply such a safe harbor test; it provides no standard for denying treaty benefits other than the rule that they may be denied if a company becomes a resident for the principal purpose of obtaining them. The safe harbor test of the U.S. model has the advantage of providing both business organizations and the countries with relative certainty as to who will be denied treaty benefits. On the other hand, the safe harbor test may limit the countries' flexibility in attacking treaty shopping abuses. Thus, the omission of the test from the anti-treaty shopping provision of the proposed treaty may, in one respect, benefit the countries' taxing authorities.

Finally, unlike the U.S. model, the proposed treaty does not limit treaty benefits with respect to foreign source income of a country's residents that bears a significantly lower tax in the residents' home country, under its laws, than similar domestic source income.

The United States arguably should maintain its policy of limiting treaty shopping opportunities whenever possible. The anti-treaty shopping provision of the proposed treaty may weaken the Treasury Department's ability to negotiate comprehensive anti-treaty shopping provisions in future treaties.

The proposed treaty's anti-treaty shopping provision may not prevent all potential unintended uses of the treaty by third-country investors. On the other hand, it is important to keep in mind that treaty shopping possibilities in China at present are apparently insignificant. In general, Chinese taxes on foreign investors are relatively high (though tax holidays to encourage investment are available). Interest and dividend payments to foreign enterprises are subject to withholding tax. With certain exceptions, interest and dividend payments to foreign individuals are subject to the individual income tax.[7] Staff is informed that foreign entities in China are subject to registration requirements that, as they are presently administered, effectively preclude the establishment of entities that would function primarily as passive investment vehicles. Staff is further informed that foreign exchange controls presently in place would make it difficult for third-country investors to channel investment income from the United States through China.

However, there is no guarantee that the present impediments to use of the proposed treaty by third-country investors will continue in the future. Changes in Chinese law and administrative practice with respect to foreign investors have been occurring at a rapid pace in recent years, and could continue to do so. Experience has shown that if abuses develop after a treaty is ratified it is very difficult to negotiate solutions.

China has announced its intention to resume the exercise of sovereignty over Hong Kong in 1997 and has concluded an agreement with Britain governing the resumption of sovereign control. Based on the terms of that agreement as they relate to the treaty definition of "China," it appears that the proposed treaty will not apply to Hong Kong. (See discussion under Article 3.) The exclusion of Hong Kong from treaty coverage is important because treaty shopping possibilities in Hong Kong, in contrast with China, might have been significant. As an international finance center seeking to attract foreign investment, Hong Kong generally imposes low income taxes. Profits earned overseas (for example, in the United States) generally are not included in arriving at taxable profits. Also, dividends paid by Hong Kong companies, income derived from trusts, and interest paid on Hong Kong bank deposits generally are exempt from Hong Kong tax. Hong Kong has no exchange controls or other rules that would restrict the movement of capital or the repatriation of profits, and places few restrictions on foreign ownership.

---

[7] It should be noted, however, that apparently no withholding mechanism for collecting the tax is presently in place. Also, the treaty substantially limits the tax; gross dividends, for example, are subject to a maximum tax of 10 percent, an unusually low treaty limit for portfolio dividends.

(4) Resourcing rule of the Tax Reform Act of 1984

The Tax Reform Act of 1984 amended the foreign tax credit limitation rules to prevent U.S. persons from treating as foreign source income dividends, interest and certain other income that they derived through a foreign corporation a significant part of whose income arose in the United States. The proposed treaty provides that the United States need credit taxes paid to China only "in accordance with the provisions of the law of the United States" (Article 22, paragraph 2). The proposed treaty also provides that income derived by a resident of one country which may be taxed in the other country under the treaty is deemed to arise in that other country (Article 22, paragraph 3).

The issue is whether the proposed treaty allows the 1984 change to the foreign tax credit limitation rules to operate as Congress intended. If the 1984 change is a provision of U.S. law limiting the foreign tax credit (for the purpose of the treaty provisions listed above), then paragraph 2 of Article 22 would control. In that case, the proposed treaty would not prevent operation of the change since the treaty credit is to be granted only "in accordance with the provisions" of U.S. law. A strong argument for this view is that the 1984 Act amended a Code section (904) that deals only with the foreign tax credit limitation. However, if instead the 1984 change is read as a source rule amendment for purposes of the proposed treaty, then paragraph 3 of Article 22 arguably would control. In that case, the proposed treaty arguably would prevent operation of the change since paragraph 3 requires foreign sourcing of certain income that would otherwise be treated as U.S. source income under the 1984 Act rule. The argument for this latter view is that the paragraph 3 source rule appears in the double taxation relief article and it would have little meaning there unless it obligated the United States to credit taxes on income that it treats as foreign source income.

At present, Chinese rules governing foreign investment probably preclude the use of a Chinese corporation to convert U.S. source income to foreign source income. However, Chinese restrictions on foreign investment have been eased considerably over the last several years and could be eased further in the future. The proposed treaty might make future payments from a Chinese corporation to a U.S. person Chinese source, even if the Chinese corporation derives all its income from the United States. That result, if it obtains, would defeat the purpose of the 1984 Code amendment. In addition, because the treaty source rule of paragraph 3 apparently applies in determining the credit allowed for foreign taxes paid to countries *other than the treaty partner* (unlike the corresponding source rule of the U.S. model which expressly prohibits such application), the impact of a future override of the 1984 resourcing amendment would reach beyond the U.S. taxation of income earned through a Chinese company. The Treasury Department interprets the proposed treaty not override the 1984 resourcing amendment. The issue for the Committee is to insure that Committee report language and Treasury's technical explanation clarify the retention of the 1984 change to the Code.

(5) Branch-level tax

The United States does not now impose a branch-level tax, but the Administration's May 1985 tax reform proposal asks Congress to enact one. The proposed treaty does not expressly prohibit the United States from imposing a branch-level tax. Many argue, however, that the nondiscrimination rule protecting permanent establishments that is found in the proposed treaty and in most U.S. income tax treaties forbids the imposition of a branch-level-type tax on permanent establishments. The Administration has responded to this argument by proposing that treaties not be overriden. On enactment, the Administration would seek to renegotiate treaties to allow the United States to impose the branch-level tax that Congress enacted as a general rule in particular countries where current treaties prohibit its imposition. The issue is whether the sequence of actions that the Administration asks Congress in general and the Senate in particular to take makes sense. If the Senate agrees to a treaty with China, for example, and then Congress enacts a branch-level tax that the treaty prevents Chinese corporations from paying, it is unclear why China would agree to allow the United States to impose that tax. China could unilaterally concede the issue, but China could instead ask for a quid pro quo from the United States, or China could instead not yield on this point. Previous experience indicates that, in general, renegotiation of treaties, once ratified, is difficult.

The Committee might address this issue in one of three ways. First, the Committee could follow the Administration's request and recommend that the Senate consent to the treaty notwithstanding this branch-level tax issue. It is not clear if or when Congress will enact a branch-level tax; if Congress does not do so, then there will have been no need for the Committee to take notice of this issue. Similarly, if Congress overrides treaties in enacting a branch-level tax, there is no need for current adverse Committee action. Overriding the treaty so soon after approval could disappoint China's legitimate expectations, however. Second, the Committee could seek a reservation allowing the United States to impose a branch-level tax if it decides to do so. This course, while it could allow the United States to collect the tax if it is enacted, could also present a condition that the Chinese Government finds unacceptable. Therefore, this course could delay or prevent the benefits of the treaty. Third, the Committee could delay action on the treaty while it awaits legislative progress on the Administration proposals for tax reform.

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income that is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income of a nonresident alien or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected.

U.S. source fixed or determinable annual or periodical income of a nonresident alien or foreign corporation (including generally interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. This tax is often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. The 30-percent (or lower treaty rate) tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence these taxes are often called withholding taxes).

Certain exemptions from the 30-percent tax are provided. Bank account interest is defined as foreign source interest and, therefore, is exempt. Exemptions are provided for certain original issue discount and for income of a foreign government from investments in U.S. securities. Under the Tax Reform Act of 1984, certain interest paid on portfolio obligations issued after July 18, 1984 (the 1984 Act's date of enactment) is exempt from the 30-percent tax. U.S. treaties also provide for exemption from tax in certain cases.

U.S. source noneffectively connected capital gains of nonresident individuals and foreign corporations are generally exempt from

U.S. tax, with two exceptions: (l) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real estate.

The source of income received by nonresident aliens and foreign corporations is determined under rules contained in the Internal Revenue Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are generally considered U.S. source income. However, if a U.S. corporation derives more than 80 percent of its gross income from foreign sources, then dividends and interest paid by that corporation will be foreign source rather than U.S. source. Conversely, dividends and interest paid by a foreign corporation, at least 50 percent of the income of which is effectively connected income, are U.S. source to the extent of the ratio of its effectively connected income to total income.

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the county in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income.

Prior to the Tax Reform Act of 1984, a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that corporation on earnings that are received as dividends. These deemed paid taxes are included in total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Separate foreign tax credit limitations are provided for DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and certain interest, respectively. Also, a special limitation applies to the credit for taxes imposed on oil and gas extraction income. The Code sometimes disregards intermediate entities to apply these limitations correctly.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation is generally accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent tax and seeks to reduce this tax (on some income to zero) in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause". Double taxation can also still arise because most countries will not exempt passive income from tax at the source.

This double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income will be exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law.

The objective of preventing tax avoidance and evasion is generally accomplished in treaties by the agreement of each country to exchange tax-related information. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further assured under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries without income tax treaties with the United States attempt to use a treaty to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, the treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

The treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against its enterprises owned by residents of the other country.

IV. EXPLANATION OF PROPOSED TAX TREATY

A detailed article-by-article explanation of the proposed income tax treaty between the United States and the People's Republic of China ("China"), as modified by the proposed protocol, is presented below, followed by separate explanations of the proposed protocol and the notes exchanged when the proposed treaty was signed.

The proposed protocol is unusual in that its signing occurred at the same time as the signing of the proposed treaty. Some of the provisions of the proposed protocol amend specific articles of the proposed treaty, while others do not. The proposed treaty and the proposed protocol, upon entry into force, would operate as one document, and it is of no consequence that some provisions appear in the proposed protocol while others appear in the body of the proposed treaty.

Article 1. (Personal scope)

Article 1 describes the persons who may claim the benefits of the treaty.

The proposed treaty applies to residents of the United States and to residents of China. Specific exceptions are designated in other articles and in the proposed protocol. This application follows other U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty. The treaty also applies, in limited cases designated in other articles, to persons who are residents of neither China nor the United States. Article 4 defines the term "resident".

Article 2. (Taxes covered)

In general, in the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Internal Revenue Code (the "Code").

The proposed protocol provides that the United States may, with one exception, impose its personal holding company and accumulated earnings taxes notwithstanding the treaty; the protocol exempts Chinese companies from these two taxes if they are wholly owned, directly or indirectly, by the Chinese Government (or any wholly owned agency thereof) or one or more individual Chinese residents (who are not U.S. citizens). The proposed protocol also provides that the United States may impose its social security tax notwithstanding the treaty.

Because the proposed treaty applies to the Federal income taxes only, it does not cover the U.S. excise tax on insurance premiums imposed under section 4371 of the Code. Accordingly, the United States may impose this tax without restriction.

In the case of China, the proposed treaty applies to the individual income tax, the income tax concerning joint ventures with Chinese and foreign investment, the income tax concerning foreign enterprises, and the local income tax.

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes that either country may subsequently impose.

The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country, within an appropriate time period, of any substantial changes in the tax laws of its country.

Article 3. (General definitions)

The proposed treaty contains certain of the standard definitions found in most U.S. income tax treaties.

The term "the People's Republic of China" means all of the territory of the People's Republic of China, including its territorial sea, in which China's internal tax laws are in force. The term also includes all the area beyond China's territorial sea, including the sea-bed and subsoil, over which China has jurisdiction in accordance with international law and in which China's internal tax laws are in force. Therefore, income earned on the Chinese continental shelf is covered.

The Chinese Government has consistently taken the view that Hong Kong is Chinese territory. However, the New Territories of Hong Kong (comprising 92 percent of the total land area of Hong Kong) have been leased to Britain since 1898 under a 99-year lease and the remaining portions of Hong Kong were ceded in perpetuity to Britain earlier in the 19th Century. China has announced its intention to resume the exercise of sovereignty over all of Hong Kong upon the expiration of the 99-year lease in 1997 and has concluded an agreement with Britain (the Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Future of Hong Kong, hereinafter referred to as the "Hong Kong Agreement") governing that resumption of sovereign control. The proposed treaty does not address directly the question of whether it will cover Hong Kong once Chinese sovereignty is resumed. However, based on the terms of the Hong Kong Agreement as they relate to the treaty definition of China, it appears that the treaty will not apply to Hong Kong. The Treasury Department takes this position.

Under the Hong Kong Agreement, China will establish a Hong Kong Special Administrative Region upon resuming the exercise of sovereignty over Hong Kong. The Hong Kong Special Administrative Region will be directly under the authority of the Central People's Government of China. However, the Hong Kong Special Administrative Region will enjoy a high degree of autonomy, except in foreign and defense affairs, and will be vested with executive, legislative, and independent judicial power under the terms of the Hong Kong Agreement. The laws currently in force in Hong Kong will remain basically unchanged for 50 years. The Hong Kong Special Administrative Region will have independent finances and the Central People's Government will not levy taxes on it. Thus, China's internal tax laws arguably will not be "in force" in Hong Kong even after sovereign control is resumed under the terms of the Hong Kong Agreement for a 50-year period. As a result, Hong Kong arguably will not be considered part of China for treaty purposes under the treaty definition of China.

The exclusion of Hong Kong from treaty coverage is important because treaty coverage could create opportunities for third-country residents to use a Hong Kong entity to obtain the treaty reductions in U.S. tax: as indicated in the discussion of treaty shopping issues above, the anti-treaty shopping provisions of the proposed treaty are very limited and Hong Kong has low tax rates and other tax and non-tax rules that make it highly attractive to foreign investors.

The proposed treaty defines "the United States" to mean all of the territory of the United States of America, including its territorial sea, in which the United States' internal tax laws are in force. The term also includes all the area beyond the United States' territorial sea, including the sea-bed and subsoil, over which the United States has jurisdiction in accordance with international law and in which the United States' internal tax laws are in force. This definition of the United States differs somewhat in form from the U.S. model definition but its meaning is intended to be the same. The definition is intended to cover the U.S. continental shelf consistent with the definition of continental shelf contained in section 638 of the Code.

The term "Contracting State" means the People's Republic of China or the United States, as the context requires.

The term "tax" means the covered Chinese taxes or the covered U.S. taxes, as the context requires.

The term "person" is defined to include an individual, a company, a partnership, and any other body of persons. The proposed protocol provides that the term also includes an estate or a trust. A "company" is any body corporate or any other entity which is treated as a body corporate for tax purposes.

An enterprise of a country is defined as an enterprise carried on by a resident of that country. Although the treaty does not define the term "enterprise", it will have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, company, partnership, or other entity.

The term "nationals" means all individuals having U.S. or Chinese nationality and all legal persons, partnerships, and other bodies of persons deriving their status as such from the laws in force in the United States or China.

The U.S. competent authority is the Secretary of the Treasury or his authorized representative. In fact, the U.S. competent authority function has been delegated to the Commissioner of the Internal Revenue Service, who has redelegated the authority to the Associate Commissioner (Operations). The Assistant Commissioner (Examination) has been delegated the authority to administer programs for simultaneous, spontaneous, and industry-wide exchange of information. The Director, Foreign Operations District, has been delegated the authority to administer programs for routine and specific exchanges of information and mutual assistance in collection.

The Chinese competent authority is the Ministry of Finance, or its authorized representative.

The treaty provides that any term not defined in the treaty is to have the meaning it has under the applicable tax laws of the country applying the treaty, unless the context requires otherwise. This provision differs from the standard U.S. treaty provision, which authorizes the two countries, in addition, to establish a common meaning for an undefined term by mutual agreement. It is the view of the countries' negotiators, however, that the countries are authorized under the mutual agreement article (Article 24) to establish a common meaning for an undefined term, this variation in treaty language notwithstanding.

Article 4. (Fiscal residence)

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence where, under the laws of the countries, a person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on U.S. source income and on his income that is effectively connected with a U.S. trade or business. A company is a resident of the United States if it is organized in the United States. Prior to the Tax Reform Act of 1984, the Code did not provide standards for determining whether an alien individual was a resident. Under U.S. Treasury regulations, an alien was a resident of the United States if he was actually present in the United States and was not a mere transient or sojourner. Whether he was a transient was determined by his intentions as to the length and nature of his stay. (See Treas. Reg. sec. 1.871-2(b).) Under the standards for determining residence provided in the 1984 Act (which were generally effective on January 1, 1985), an individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident. A permanent resident for immigration purposes also is a U.S. resident. The standards for determining residence provided in the 1984 Act do not apply in determining the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States).

Under the proposed treaty, a person (either an individual or an entity such as a corporation or a partnership) is considered to be a resident of a country if, under the laws of that country, the person is liable to taxation by that country because it is his country of domicile, residence, place of head office, place of incorporation, or by reason of other criteria of a similar nature.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. and OECD model treaties and is similar to the provisions found in other U.S. tax treaties. However, the provision differs in certain respects from those found in the other treaties. For example, it does not explicitly exclude from treaty coverage persons who are taxable in one of the countries only with respect to income from sources in that country or capital situated in that country. Despite this omission, it is understood that third-country residents liable to tax in China or the United States only with respect to income from sources in (or capital situated in) China or the United States will not be eligible for benefits under the treaty.

Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not entitled to the benefits of the treaty as U.S. residents. This result is contrary to U.S. treaty policy as expressed in the U.S. model, but the U.S. model result has been achieved in very few treaties.

In the case of a dual resident individual, residence for treaty purposes is to be determined by the competent authorities of the two countries through consultations. In determining the treaty residence of a dual residence individual, the competent authorities are, under the protocol, to be guided by the "tie-breaker" rules contained in the corresponding article of the United Nations model treaty. Under these rules, if one criterion does not determine a single residence, the second criterion comes into consideration, and so on. The tie-breaker rules of the United Nations model treaty are identical to those of the U.S. model treaty. However, the U.S. model treaty and most recent U.S. income tax treaties differ from the proposed treaty in permitting the application of the tie-breaker rules by one country without consultation with the competent authority of the other country. Resolution of an issue under the competent authority mechanism may take a substantial amount of time.

In the case of a dual resident company, residence for treaty purposes, again, is to be determined by the competent authorities of the two countries through consultations. If the competent authorities are unable to reach a determination, the company will not be considered a resident of either country under the treaty. This rule differs from that of the U.S. model. Under the U.S. model, a dual resident company that is created under the laws of one of the countries is deemed a resident of that country for treaty purposes.

A company that is both a U.S. resident under the general rule of this article and a resident of a third country under a tax agreement between that third country and China will not be considered a U.S. resident for purposes of enjoying the benefits of the proposed treaty. This rule could disqualify U.S.-incorporated companies doing business in China that are considered to be managed in, and therefore, residents of, other Chinese treaty partners, from the reductions in Chinese tax provided by the proposed treaty. This rule is not contained in the U.S. model or in recent U.S. income tax treaties.

Article 5. (Permanent establishment)

The proposed treaty contains a definition of the term "permanent establishment" that, with certain exceptions, follows the pattern of other recent U.S. income tax treaties, the U.S. model and the OECD model. Certain aspects of the definition are modeled after the permanent establishment definition of the United Nations model treaty.

The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties will apply, or whether those amounts will be taxed as business profits. U.S. taxation of business profits is discussed under Article 7.

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which a resident of one country engages in business in the other country. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, or other place of extraction of natural resources.

A permanent establishment also includes any building site, construction, assembly, or installation project, or supervisory activities performed in connection therewith, if the site, project, or activities continue for a period of more than six months. This provision is modeled upon the corresponding provision of the United Nations model treaty. The U.S. model treaty contains a somewhat similar provision. However, the U.S. model provision utilizes a twelve-month rule rather than a six-month rule. Also, the U.S. model treaty does not treat supervisory activities performed in connection with a building site, etc., by themselves, as a permanent establishment.

An installation, drilling rig, or ship used for the exploration or exploitation of natural resources will constitute a permanent establishment if it is used for those purposes in one of the countries (as they are defined in the treaty) for a period of more than three months. This three-month rule differs from the twelve-month rule of the U.S. model treaty.

The furnishing of services by an enterprise, including consultancy services, through employees or other personnel engaged by the enterprise for that purpose will give rise to a permanent establishment if the activities continue (for the same or a connected project) within a country for a period or periods aggregating more than six months within any twelve-month period. This provision, which does not require a fixed place of business for there to be a permanent establishment, is similar to one included in the United Nations model treaty. It is not found in the U.S. model treaty but has been included, in roughly similar form, in some recent U.S. income tax treaties with developing countries (e.g., Jamaica and the Philippines).

The general permanent establishment rule is modified to provide that a fixed place of business that is used for any of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise and the maintenance of a stock of goods belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information, or solely for the purpose of carrying on, for the enterprise, any other preparatory or auxiliary activity. Under the proposed treaty, a fixed place of business used solely for any combination of the above-mentioned activities will not constitute a permanent establishment provided that the overall activity of the fixed place of business is of a preparatory or auxiliary character.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other country, then the enterprise will be deemed to have a permanent establishment in the first country. This rule does not apply where the contracting authority is limited to those activities, such as storage, display, or delivery of merchandise (described above), that are excluded from the definition of permanent establishment. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business. However, the proposed treaty adds the limitation that, when the activities of an agent are devoted wholly or almost wholly on behalf of one enterprise, the agent will not be considered an independent agent if the transactions between it and that enterprise were not made under arm's-length conditions.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. Any such relationship is thus not relevant; only the activities of the company being tested are relevant.

Article 6. (Income from real property)

This article covers income from real property. The rules governing gains from the sale of real property are in Article 12.

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be taxed in the country where the real property is located.

The term "real property" has the meaning which it has under the law of the country in which the property in question is situated. The term in any case includes property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property, and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Thus, income from real property will include royalties and other payments in respect of the exploitation of natural resources (e.g., oil). It does not include interest on loans secured by real property. Ships and aircraft are not real property.

The source country may tax income derived from the direct use, letting, or use in any other form of real property. These rules allowing source country taxation also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

The U.S. model treaty and certain other U.S. income tax treaties permit a resident of one country to elect to be taxed on a net basis by the other country on income from real property in that other country. The proposed treaty does not contain that election, but such an election is provided for U.S. real property income under the Code (secs. 871(d) and 882(d)).

Article 7. (Business profits)

U.S. Code rules

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30 percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

Foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock or debt derived in the active conduct of a banking, financing or similar business in the United States; and certain sales income attributable to a U.S. sales office.

Except in the case of a dealer, trading in stocks, securities, or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent or trading by a foreign person physically present in the United States.

Proposed treaty rules

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

Unlike many U.S. treaties and the U.S. model treaty, the proposed treaty does not define the term "business profits." To the extent not dealt with in other articles, the term either will be defined under the law of the country applying the treaty or (apparently) by mutual agreement of the two countries. The proposed treaty may thus leave it to Chinese law, for example, to determine whether an item of income not dealt with elsewhere in the treaty that is earned by a U.S. company through a permanent establishment in China constitutes business profits and, therefore, is taxable by China under this treaty article.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to a permanent establishment the business profits that would reasonably be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. For example, this arm's-length rule applies to transactions between a permanent establishment and an office of the resident enterprise located in a third-country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions generally are allowed for expenses, wherever incurred, that are incurred for the purposes of the permanent establishment. These deductions include executive and general administrative expenses. However, no deduction will be allowed for amounts paid (other than in reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or to any of its other offices, by way of royalties or other similar payments or by way of interest on money lent to the permanent establishment. Similarly, no account will be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or to any of its other offices, by way of royalties or other similar payments or by way of interest on money lent to the head office of the enterprise or to any of its other offices. These rules limiting deductions, which are not found in the U.S. or OECD model treaty, are patterned after rules contained in the United Nations model treaty. Similar rules are contained in certain other U.S. income tax treaties with developing countries.

The treaty expressly reserves to each country the right to determine taxable profits in a specific industry on a deemed basis where the country's internal law provides for the determination of taxable profits in that industry on a deemed basis and the result is in accordance with the principles of this article. Staff is informed that it is generally China's practice to deem as taxable profits 10 percent of the Chinese source gross receipts of U.S. subcontractors from offshore oil operations. Staff is further informed that China deems as taxable profits 10 percent of the Chinese source gross receipts with respect to outgoing traffic received by operators of ships and aircraft in international traffic. In both cases, a 50-percent tax is imposed on the deemed profits. Thus, the treaty, for example, will permit China to collect a tax from a U.S. oil driller equal to five percent of the gross receipts, if any, attributable to a drilling rig of the driller that is situated in, and remains for more than three months in, the South China Sea, provided this tax is in accordance with the principles of this article. Under the agreement currently in force between the United States and China governing the taxation of shipping and aircraft income, income earned by a U.S. enterprise from the operation of ships or aircraft in international traffic is exempt from Chinese tax. The U.S. model treaty does not reserve to a country the right to determine profits on a deemed basis.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities. The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

Where business profits include items of income that are dealt with separately in other articles of the treaty, those other articles, and not this business profits article, generally will govern the treatment of those items of income. Thus, for example, dividends generally are taxed under the provisions of Article 9 and not as business profits.

Article 8. (Related persons)

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to section 482 of the Code that recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements that would have been made between independent enterprises.

For purposes of the proposed treaty an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. The enterprises are also related if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

When a redetermination of tax liability has been properly made by one country, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making that adjustment, due regard is to be paid to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary.

The proposed treaty omits the usual provision stating that this article is not intended to limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between non-independent persons when such law is necessary to prevent evasion of taxes or to reflect clearly the income of those persons. That provision makes it clear that the United States retains the right to apply its inter-company pricing rules (Code sec. 482) and its rules relating to the allocation of deductions (Code secs. 861, 862, and 863, and Treas. Reg. sec. 1.861-8). Notwithstanding the omission of this provision, the countries' negotiators reportedly agreed that the United States would retain the right under the proposed treaty to apply its inter-company pricing and deduction allocation rules.

Article 9. (Dividends)

The United States imposes a 30-percent withholding tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates, on a net basis. U.S. source dividends, for purposes of the 30-percent tax, are dividends paid by a U.S. corporation (other than an "80/20 company" described in Code sec. 861(a)(2)(A)). Also treated as U.S. source dividends for this purpose are certain dividends paid by a foreign corporation, if at least 50 percent of the gross income of the foreign corporation, in the prior three-year period, was effectively connected with a U.S. trade or business of that foreign corporation. The tax imposed on the latter dividends is often referred to as the "second tier" withholding tax.

Under the proposed treaty, each country may tax dividends paid by its resident companies but the tax is generally limited to 10 percent of the gross amount of the dividends if the recipient of the dividends is a resident of the other country and is the beneficial owner of the dividends. This rule does not restrict the right of a country to tax the profits out of which dividends are paid. Under the U.S. model, source country tax is limited to five percent on dividends paid to "direct" investors (i.e., companies which own at least 10 percent of the voting stock of the company paying the dividends) and to 15 percent on dividends paid to "portfolio" investors (i.e., investors other than direct investors).

Like the U.S. model treaty, the proposed treaty defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. Dividends also include income from other corporate rights which is subjected to the same tax treatment by the country in which the distributing corporation is resident as income from shares. Under this provision, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest.

The treaty limitation on source country dividend tax will not apply if the beneficial owner of the dividend has a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the shareholding or other corporate right with respect to which the dividends are paid is effectively connected with the permanent establishment (or fixed base). Dividends paid on shareholdings or other corporate rights effectively connected with a permanent establishment are to be taxed as business profits (Article 7). Dividends paid on shareholdings or other corporate rights effectively connected with a fixed base are to be taxed as income from independent personal services (Article 13).

The proposed treaty limits the right of a country to tax dividends paid by a company resident in the other country that derives profits or income in the first country. The country in which the company is not resident may tax dividends paid by the company only if they are paid to a resident of that country or if the shareholding or other corporate rights with respect to which the dividends are paid are effectively connected with a permanent establishment or fixed base maintained in that country. Unlike the U.S. model treaty, the proposed treaty does not allow one country to tax dividends paid by a resident company of the other country on the basis that the dividends are from gross income of its permanent establishment in the first country constituting 50 percent or more of its worldwide income. The effect of this departure from the U.S. model is to waive the United States' second tier withholding tax on dividends paid by foreign companies earning 50 percent or more of their income from U.S. business. This provision follows the OECD and United Nations model treaties.

The proposed treaty also exempts the undistributed profits of a company resident in one country that derives profits or income in the other country from the second country's tax on undistributed profits. The exemption applies even if the undistributed profits consist wholly or partly of profits or income arising in the second country. The U.S. model treaty does not include this exemption; the OECD and United Nations model treaties do.

Article 10. (Interest)

In general, the United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. However, the Tax Reform Act of 1984 repealed the tax for interest paid on certain portfolio indebtedness to nonresident alien individuals and foreign corporations. (This change was effective for interest paid on portfolio indebtedness issued after July 18, 1984, the date of enactment of the 1984 Act.) U.S. source interest, for purposes of the 30-percent tax, generally is interest on debt obligations of U.S. persons, but not interest on deposits in banks. U.S. source interest for this purpose also includes interest paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three-year period, was effectively connected with a U.S. trade or business of that corporation. The tax imposed on the latter interest is often referred to as the "second tier" withholding tax.

Under the proposed treaty, each country may tax interest arising within that country, but the tax is generally limited to 10 percent of the gross amount of the interest if its recipient is a resident of the other country and is the beneficial owner of the interest. This limitation on source country tax does not apply if the recipient of the interest is a nominee for a nonresident. (The protocol provides additional rules intended to prevent treaty shopping.) The 10-percent limitation contrasts with the U.S. model position, not generally achieved, that interest generally should be exempt from tax at source.

In certain cases, interest *will* be exempt from tax at source under the proposed treaty. These are where the interest is derived by the government of the other country, or a political subdivision or local authority in that other country; the interest is derived by the Central Bank of the other country; the interest is derived by any financial institution wholly owned by the government of the other country; or the interest is derived by any resident of the other country with respect to debt-claims indirectly financed by any of the entities just described. Since China's economy is socialist, the effect of this treatment will be to exempt most interest paid to Chinese recipients from U.S. tax without a general reciprocal exemption.

Neither the 10-percent limitation nor the exemptions will apply if the beneficial owner of the interest has a permanent establishment or fixed base in the source country and the debt-claim is effectively connected with the permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 13).

The proposed treaty provides source rules for interest. Interest generally will be considered to arise within a country if the payor is the government of that country, including political subdivisions and local authorities, or a resident of that country. Generally, this rule is consistent with U.S. source rules which provide that interest (other than certain interest paid by foreign corporations) is sourced in the country in which the payor is resident. The treaty also provides, however, that if interest is borne by a permanent establishment (or fixed base) that the payor has in one of the countries and the indebtedness was incurred with respect to that permanent establishment (or fixed base), then the interest will be sourced in that country, regardless of the residency of the payor.

These source rules effectively prohibit one country from taxing interest paid by a resident company of the other country on the basis that the interest is from profits of its permanent establishment in the first country constituting 50 percent or more of its worldwide income. The effect of this departure from the U.S. model is to waive the United States' second tier withholding tax on interest paid by foreign companies earning 50 percent or more of their income from U.S. business.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by holding that the amount of interest for purposes of applying this article will be the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest, for whatever reason, will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 9 of the proposed treaty.

The proposed treaty defines "interest" as income from debt-claims of every kind, whether or not secured and whether or not carrying a right to participate in profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to bonds or debentures.

Article 11. (Royalties)

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangibles in the United States. Such royalties include motion picture royalties.

Under the proposed treaty, each country may tax royalties arising within that country, but the tax is generally limited to 10 percent of the gross amount of the royalties if their recipient is a resident of the other country and is the beneficial owner of the royalties. In the case of royalties paid for the rental of industrial, commercial, or scientific equipment, the proposed protocol provides that source country tax may be imposed on 70 percent of the gross amount of the royalties only. This protocol provision effectively limits to seven percent the maximum source country tax on these types of royalties. The U.S. model treaty exempts royalties from tax at source.

The 10- and seven-percent tax limitations will not apply if the recipient of the royalty is a nominee for a nonresident. They also will not apply if the recipient is an enterprise with a permanent establishment in the source country or an individual performing personal services in an independent capacity through a fixed base in the source country, and the property giving rise to the royalty is effectively connected with the permanent establishment or fixed base. In that event, the royalties will be taxed as business profits (Article 7) or as income from the performance of independent personal services (Article 13).

The proposed treaty defines "royalties" as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work including cinematographic films, films or tapes used for radio or television broadcasting, any patent, technical know-how, trade mark, design or model, plan, secret formula, or process. Royalties are also payments of any kind received as consideration for the use of or the right to use industrial, commercial, or scientific equipment, or for information concerning such equipment. The treaty's royalty definition follows that of the OECD and United Nations models.

The proposed treaty provides special source rules for royalties that differ somewhat from the U.S. source rules for royalties. Generally, as indicated above, under U.S. tax rules (Code secs. 861-62), royalty income is sourced where the property or right is being used. Under the proposed treaty, if a royalty is paid by the government of one of the countries, including political subdivisions and local authorities, or by a resident of one of the countries, then the royalty generally will be sourced in the country of residence of the payor. However, if the payor has a permanent establishment or fixed base in one of the countries in connection with which the obligation to pay the royalty was incurred, and if the royalty is borne by permanent establishment or fixed base, then the royalty arises in the country in which the permanent establishment or fixed base is situated. If these rules do not result in the sourcing of the royalty in the United States or China, and if the royalty relates to the use of or the right to use the right or property in one of the two countries, then the royalty is treated as arising in that country.

The treaty source rules for royalties derive primarily from notes accompanying the United Nations model treaty. The U.S.-New Zealand income tax treaty, ratified in 1983, contains similar source rules for royalties.

The proposed protocol addresses the issue of non-arm's-length royalties between related parties (or parties having an otherwise special relationship) by holding that the amount of royalties for purposes of applying this article will be the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length royalty will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 9 of the proposed treaty.

Article 12. (Gains)

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations holding U.S. real property.

Under the proposed treaty, gains from the disposition of movable (personal) property that forms part of the business property of a permanent establishment that an enterprise of one country has or had in the other country, or gains from the alienation of movable (personal) property pertaining to a fixed base available to a resident of one country in the other country for the purpose of performing independent personal services, including gains from the disposition of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base, may be taxed in that other country.

Gains derived by a resident of one country from the disposition of ships or aircraft operated in international traffic, and from the disposition of movable (personal) property pertaining to the operation of such ships or aircraft are taxable only in that country.

Gains from the disposition of real property may be taxed in the country where the real property is situated. Real property for this purpose is defined as it is under the article governing taxation of income from real property (Article 6). In addition, gains from the disposition of shares of the capital stock of a company whose property consists (directly or indirectly) principally of real property situated in a country may be taxed in the situs country. Unlike the U.S., OECD, and United Nations model treaties, the proposed treaty provides that gains arising in one country from the disposition by a resident of the other country of any property not referred to elsewhere in the gains article may be taxed in the first country. Taken together, these rules are intended to allow the United States to tax any transaction of a Chinese resident otherwise taxable under FIRPTA. While the treaty definition of real property under Article 6 may not encompass all "U.S. real property interests" whose disposition is taxable under FIRPTA, assigning the source country a right to tax any property gains not referred to elsewhere in the article apparently safeguards the U.S. tax. The latter rule is understood to allow the United States to tax, among other real property gains, gains from the disposition of interests in partnerships, trusts, and estates to the extent attributable to U.S. real property interests, since such gains are considered under FIRPTA to be derived from the disposition *in the United States* of such property. (See Code sec. 897(g).)

Gains from the disposition of shares (other than shares in a company whose property is principally real property, as discussed above) representing a 25-percent (or greater) participation in a company resident in a country may be taxed in that country. This provision is taken from the United Nations model treaty; neither the U.S. model nor the OECD model includes it.

Article 13. (Independent personal services)

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7.) The performance of personal services within the United States can be a trade or business within the United States (Code sec. 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from salaries, wages, and similar remuneration received by employees.

Under the proposed treaty, income derived by an individual resident in one country from professional services or other activities of an independent character may be taxed in the other country in two cases only. The nonresident country may tax the income if the individual has a fixed base regularly available to him or her in the nonresident country for the purpose of performing his or her other activities. Only that portion of the individual's income attributable to the fixed base may be taxed in the nonresident country. The nonresident country also may tax the individual's independent personal services income if the individual is present in the nonresident country for more than 183 days during the calendar year concerned. In that case, only that portion of the individual's income derived in the nonresident country while the individual was present there may be taxed in the nonresident country.

This partial exemption from tax parallels that provided for independent personal services income under the United Nations model treaty. The U.S. model treaty provides a broader tax exemption for such income: the U.S. model does not contain a 183-day rule; it allows taxation in the nonresident country only on the basis of a fixed base regularly available there to the individual performing the independent personal services.

The term "professional services" includes independent scientific, literary, artistic, educational, and teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

Article 14. (Dependent personal services)

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days during a taxable year, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign office or place of business of a U.S. person.

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will be taxable only in the residence country if three requirements are met: (1) the recipient is present in the source country for fewer than 184 days during the calendar year concerned; (2) the employer of the recipient is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country. Under the U.S. model, the fewer-than-184-day-test is computed on the basis of the tax year, not on the basis of the calendar year. However, because most individual U.S. taxpayers use the calendar year as their tax year, this departure from the U.S. model is of little significance.

This article is modified in some respects for directors' fees (Article 15), pensions (Article 17), compensation of government employees (Article 18), remuneration for teaching, lectures, and research (Article 19), and income of students, business apprentices, and trainees (Article 20). In addition, income derived as an entertainer or athlete is taxed in accordance with special rules (Article 16).

Article 15. (Directors' fees)

Under the proposed treaty, directors' fees and similar payments derived by a resident of one country in his or her capacity as a member of the board of directors of a company that is a resident of the other country may be taxed in that other country.

This rule for directors' fees follows the OECD model. It differs from the rule of the U.S. model treaty. The U.S. model treats directors' fees as personal services income or distributed profits, primary taxing jurisdiction over which generally belongs to the country where the recipient resides.

Article 16. (Entertainers and athletes)

The proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes" or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 13 and 14), and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under the proposed treaty, income derived by entertainers and athletes resident in one country from their personal activities as such exercised in the other country generally may be taxed in that other country. However, such income will be exempt from tax in the source country if the personal activities are exercised in accordance with a special program for cultural exchange agreed upon by the governments of the United States and China. This exemption from source country taxation differs from that provided by the U.S. model treaty and most U.S. income tax treaties for entertainers' and athletes' income. Under the U.S. model treaty, entertainers' and athletes' income from their activities as such is exempt from tax in the source country if the gross receipts from those activities derived in the source country are $20,000 or less for the year. (The dollar amount is lower in most U.S. income tax treaties). There is no separate rule in the U.S. model for income derived in connection with participation in a cultural exchange program.

Staff is informed that U.S. entertainers and athletes presently perform in China (and Chinese entertainers and athletes presently perform in the United States) only in accordance with cultural exchange programs approved by the two countries. So long as this practice continues, the proposed treaty rule, as a practical matter, will exempt entertainers' and athletes' income from tax at source.

The proposed treaty provides that where income in respect of personal activities performed by an entertainer or athlete in his capacity as such accrues not to the entertainer or athlete, but to another person, that income may be taxed by the country in which the activities are exercised. (This provision applies notwithstanding the business profits and personal services articles (Articles 7, 13, and 14)). This provision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or a trust located in a country that would not tax the income. The provision does not apply to income otherwise exempt from source country taxation under this article (i.e., income derived by an entertainer or athlete in connection with participation in a special program for cultural exchange). The corresponding provision of the U.S. model treaty, by contrast, does apply to income that would otherwise be exempt from source country taxation under this article.

Article 17. (Pensions)

Under the proposed treaty, pensions and other similar remuneration paid to a resident of either country in consideration of past employment generally are subject to tax only in the recipient's country of residence.

The above rule does not apply to pensions paid to a resident of one country attributable to services performed for governmental entities of the other unless the recipient is also a national of the first country (see Article 18). The general rule also does not apply to pensions and other payments from the government or a political subdivision or local authority of a country under its social security system or public welfare plan; such pensions and other payments may be taxed in that country only. For example, only the United States may tax U.S. social security payments to U.S. persons residing in China. The article thus safeguards the United States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by nonresident individuals, while protecting any such individuals residing in China from double taxation.

The corresponding article of the U.S. model treaty contains rules for annuities, alimony payments, and child support payments that the proposed treaty does not contain. Under the U.S. model treaty, annuities and alimony payment (and other maintenance payments other than child support payments) are taxable only by the country of residence of the recipient, while child support payments are taxable only by the country of the payor. The child support rule in the U.S. model is not subject to the saving clause. Under the proposed treaty, annuities, alimony payments, and child support payments are covered under Article 21: under that article, they may be taxed in both the country of residence of the recipient and the country where they arise.

Article 18. (Government service)

The proposed treaty generally exempts the wages of employees of one of the countries from tax in the other country.

Under the proposed treaty, remuneration, other than a pension, paid by the government of a country or one of the country's political subdivisions or local authorities to an individual for services rendered to the government (or subdivision or authority) generally will be taxable in that country only. However, such remuneration will be taxable only in the other country (the country not the payor) if the services are rendered in that other country and the individual is a resident of that other country who either (1) is a national of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, China would not tax the compensation of a U.S. national and resident who is in China to perform services for the U.S. Government. The United States would not tax the compensation of a Chinese national and resident who performs services for the U.S. Government in China.

Any pension paid by, or out of funds created by, the government of a country or one of the country's political subdivisions or local authorities to an individual for services rendered to the government (or subdivision or authority) generally will be taxable only in that country. However, such a pension will be taxable only in the other country if the individual is both a resident and a national of that other country.

The above rules follow those of the OECD and United Nations model treaties. In the situations described above, the U.S. model treaty assigns exclusive taxing jurisdiction to the paying country, but only in the case of payments to one of its citizens.

If the government of a country or one of the country's political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature), the provisions of Articles 14, 15, 16, and 17 will apply to remuneration and pensions for services rendered in connection with that business.

The saving clause (discussed under the proposed protocol below) overrides this article in the case of U.S. citizens, but not in the case of U.S. residents who are not U.S. citizens.

Article 19. (Teachers and researchers)

An individual temporarily present in one country for the primary purpose of teaching, giving lectures, or conducting research at a university, college, school, or other accredited educational institution or scientific research institution in that country will be exempt from tax in that country for three years on remuneration for the teaching, lecturing, or research if he or she is a resident of the other country or was such a resident immediately before visiting the host country. Under this provision, a U.S. professor, for example, who visits China for nine months for the primary purpose of teaching at a Chinese university will be exempt from Chinese tax on remuneration the professor receives for the teaching. However, the professor may be taxed by China under the 183-day-presence-rule of Article 13 on any other independent personal services income (e.g., income from consulting) that the professor may earn while in China.

A number of U.S. income tax treaties provide a similar exemption for visiting teachers and researchers. However, the exemption provided in other U.S. treaties typically is for two years, not three. Unlike the proposed treaty, some U.S. treaties expressly limit the exemption, in the case of income from research, to income from research undertaken in the public interest rather than primarily for private benefit.

The U.S., OECD, and United Nations model treaties do not contain a special exemption for visiting teachers and researchers.

Article 20. (Students, apprentices, and trainees)

A student, business apprentice, or trainee who is present in one of the countries solely for the purpose of his or her education or training or obtaining special technical experience will be exempt from tax in that country with respect to certain income if he or she is a resident of the other country, or was such a resident immediately before visiting the host country. The host country tax exemption applies to (1) payments received from abroad for the purpose of the individual's maintenance, education, study, research, or training; (2) grants and awards from governmental, scientific, educational, or other tax-exempt organizations, and (3) $5,000 per taxable year of income from personal services performed in the host country. The exemption extends only for as long as is reasonably necessary to complete the education or training.

This exemption for visiting students, apprentices, and trainees is broader than that provided in the U.S. and OECD model treaties. Among other differences, the exemption in the model treaties applies only to the first of the three categories of income eligible for the exemption under the proposed treaty. The exemption provided in the proposed treaty is similar to that incorporated in some other U.S. income tax treaties with developing countries. It differs, however, from the exemption provided in most of these other treaties in not terminating after a fixed number years (typically five) and in applying to $5,000 per year of personal services income rather than $2,000 or $3,000.

Article 21. (Other income)

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or China. Thus, it applies to income from third countries as well as to income from the United States and China.

As a general rule, items of income not otherwise dealt with in the proposed treaty that are derived by residents of either country will be taxable only in the country of residence. This rule, for example, gives the United States the sole right under the treaty to tax income sourced in a third-country and paid to a resident of the United States. This article is subject to the saving clause (included in the proposed protocol) in the case of U.S. citizens, so U.S. citizens who are Chinese residents will continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to China.

The general rule just stated does not apply if the recipient of the income (other than income from real property (Article 6)) is a resident of one country and carries on business in the other country through a permanent establishment or a fixed base, and the right or property in respect of which the income is paid is effectively connected with the permanent establishment or fixed base. In such a case, the provisions of Article 7 (business profits) or Article 13 (independent personal services), as the case may be, will apply.

Moreover, notwithstanding either of the above two rules, if a resident of one country receives income not dealt with elsewhere in the treaty that arises in the other country, the income may be taxed in that other (source) country. A number of existing U.S. income tax treaties apply this rule, but it is not included in the U.S. and OECD model treaties, which generally give the sole right to tax "other income" to the country of residence.

This article is substantially identical to the corresponding article of the United Nations model treaty.

Article 22. (Relief from double taxation)

Background

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. This limitation is generally computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for oil extraction income, DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and certain interest.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends (deemed paid credit) (Code sec. 902). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles that limit the right of a source country to tax income and that coordinate the source rules. This article provides further relief where both China and the United States will still tax the same item of income. China waives its overriding taxing jurisdiction to the extent that this article applies; the United States does the same with respect to U.S. residents who are not U.S. citizens.

The proposed treaty provides separate rules for relief from double taxation for the United States and China.

United States

Under the proposed treaty, the United States will allow a foreign tax credit to a U.S. resident or U.S. citizen for income tax paid to China by or on behalf of the U.S. resident or citizen. The proposed treaty further provides that the United States will allow a deemed paid credit to a U.S. corporate shareholder of a Chinese company receiving a dividend from the Chinese company if the U.S. corporate shareholder owns 10 percent or more of the voting rights in the Chinese company. This credit will be allowed for the income tax paid to China, by or on behalf of the distributing Chinese company, on the profits out of which the dividends are paid. Both the regular and deemed paid foreign tax credits are to be determined in accordance with the provisions of U.S. law.

The proposed treaty provides that all Chinese taxes covered by the treaty (Article 2) are considered income taxes for purposes of the U.S. foreign tax credit. Accordingly, all such Chinese taxes will be eligible for the U.S. foreign tax credit under the proposed treaty. Although the matter is not entirely free from doubt, these taxes probably would be creditable in the absence of the proposed treaty under U.S. Treasury Department regulations. The Internal Revenue Service has ruled favorably on the creditability of the individual income tax, the income tax concerning foreign enterprises, and the local income tax in private letter rulings issued under an earlier version of the Treasury regulations. The Service has not ruled on the creditability of the income tax on joint ventures.

The proposed treaty provision governing the U.S. foreign tax credit is similar to that found in the U.S. model treaty and in many U.S. income tax treaties.

China

The proposed treaty provides that China is to credit against the Chinese tax imposed on a Chinese resident any U.S. income tax payable under the treaty on the Chinese resident's U.S. source income. The amount of the credit may not exceed the amount of the Chinese tax (computed in accordance with the tax laws and regulations of China) on the U.S. source income. The proposed treaty further provides that China is to allow a credit to a Chinese company receiving a dividend from a U.S. resident company whose shares are owned 10 percent or more by the Chinese company. The credit is to take into account the U.S. income tax payable by the distributing U.S. company on the profits out of which the dividends are paid. All U.S. taxes covered by the treaty (Article 2) are considered income taxes for purposes of the Chinese foreign tax credit.

Source rule

The double taxation article contains a special source rule. Income derived by a resident of one country that may be taxed in the other country under the proposed treaty is deemed to arise in that other country. This source rule is not expressly limited to the double tax relief article, as the corresponding source rule of the U.S. model is. The proposed treaty also omits the U.S. model provision stating that this source rule does not apply in determining foreign tax credits for foreign taxes paid by U.S. residents to third countries.

Article 23. (Nondiscrimination)

The proposed treaty contains a nondiscrimination article relating to the taxes covered by the treaty. It is similar to the nondiscrimination article in the U.S. model treaty and to nondiscrimination articles that have been embodied in other recent U.S. income tax treaties.

In general, under the proposed treaty, one country cannot discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its nationals in the same circumstances. Under both the proposed treaty and the U.S. model, this provision applies whether or not the nationals in question are residents of one or both of the countries. This rule of application is qualified in the U.S. model by the rule that a U.S. national residing outside the United States and a national of the U.S. treaty partner residing outside the United States are not in the same circumstances for U.S. tax purposes. The proposed treaty omits this qualifying language but staff is informed that the countries' negotiators did not intend the omission to imply a change of meaning from the U.S. model.

As indicated above (under Article 3), "nationals" are defined as individuals having the nationality of the United States or China and all legal persons, partnerships, and other bodies of persons deriving their status as such from the laws in force in the United States or China. This definition corresponds closely to that contained in the OECD and United Nations model treaties. Under the U.S. model treaty, by comparison, only U.S. citizens qualify as U.S. nationals for purposes of obtaining nondiscrimination benefits.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprise carrying on the same activities. Consistent with the U.S., OECD, and United Nations model treaties, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

Each country is required (subject to the arm's-length pricing rules of Articles 8 (related persons), 10(7) (interest), and 11(6) (royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The term "other disbursements" is understood to include a reasonable allocation of executive and administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group or related enterprises.

The rule of nondiscrimination also applies to corporations of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one of more residents of the other country, will not be subjected in the first country to any taxation or any connected requirement that is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises.

The nondiscrimination article does not override the right of the United States to tax foreign corporations on their dispositions of U.S. real property interests because the effect of the provisions imposing such tax is not discriminatory. The election to be treated as a U.S. corporation under Code section 897(i) precludes the possibility of discrimination.

The saving clause (see discussion of the protocol below) applies to this nondiscrimination article in the case of U.S. citizens. It does not apply in the case of U.S. residents who are not U.S. citizens.

Article 24. (Mutual agreement procedure)

The proposed treaty contains a mutual agreement provision that authorizes the competent authorities of the United States and China to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The application of this provision may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by China and, in the case of U.S. residents who are not U.S. citizens, by the United States. The mutual agreement provision of the proposed treaty follows the standard provision of the U.S. model, with a few differences.

Under the proposed treaty, a person who considers that the actions of one or both of the countries will cause him or her to pay a tax not in accordance with the treaty may present his or her case to the competent authority of the country of which he or she is a resident. The person also may present his or her case to the competent authority of the country of which he or she is a national (but not a resident), but only if the case comes under the nondiscrimination article. The latter rule follows the United Nations model treaty; under the U.S. model treaty, a person may present his or her case to the country of which he or she is a national (but not a resident) without any restriction as to the treaty article under which the case arises.

A person must present his or her case to the competent authority within three years from the first notification of the action that will cause the person to pay tax not in accordance with the treaty. This three-year time limit is taken from the United Nations model; the U.S. model treaty does not impose a time limit on the presentation of a person's case.

Upon the timely presentation of a person's case, the competent authority will make a determination as to whether the objection appears justified. If the objection appears to the competent authority to be justified and if it is not itself able to arrive at a satisfactory solution, then the competent authority will endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation that is not in accordance with the treaty. This provision requires the waiver of the internal statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding that statute of limitations. However, the provision does not authorize the imposition of additional taxes after the statute of limitations has run.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty. Unlike the U.S. model treaty, the proposed treaty does not enumerate particular matters to which the competent authorities might agree. However, the countries' negotiators intended that, as under the U.S. model, the competent authorities be authorized to agree to the allocation of income, deductions, credits, or allowances, to the determination of the source of income, and to the common meaning of terms.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. It also authorizes them to meet together for an oral exchange of opinions in order to facilitate reaching an agreement. These provisions make clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the treaty. They also remove any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or China.

Article 25. (Exchange of information)

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can property administer the treaty. It follows the exchange of information article of the U.S. model treaty, with some significant modifications. It is also similar to the exchange of information articles found in the United Nations and OECD model treaties.

The proposed treaty provides for the exchange of information that is necessary to carry out the provisions of the proposed treaty or the provisions of the domestic laws of the two countries concerning taxes to which the treaty applies insofar as the taxation under those domestic laws is not contrary to the treaty. Following the United Nations model treaty rather than the U.S. model, the proposed treaty states that such exchange of information will be, in particular, for the prevention of fraud or evasion of the covered taxes.

The exchange of information under the proposed treaty is not restricted by Article 1; thus, third-country residents are covered. The U.S. model treaty provides for the exchange of information regarding all taxes imposed by either country (whether or not otherwise covered by the treaty). The exchange of information provided for in the proposed treaty is more limited: the proposed treaty authorizes the exchange only of information regarding taxes generally covered by the treaty (Article 2).

Any information exchanged is to be treated as secret. Exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the treaty applies. Such persons or authorities can use the information for such purposes only. They may disclose the information in public court proceedings or in judicial decisions. Persons involved in the administration of taxes include legislative bodies involved in oversight of the administration of taxes, including their agents such as, for example, the U.S. General Accounting Office, with respect to such information as they consider necessary to carry out their oversight responsibilities.

The proposed treaty contains limitations on the obligations of the countries to supply information. A country is not required to carry out administrative measures at variance with the law and administrative practice of either country, or to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

The U.S. model treaty requires that, upon an appropriate request for information, the requested country obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. It also requires that, where specifically requested by the competent authority of one country, the competent authority of the other country provide the information in the form requested. The proposed treaty does not contain these requirements.

The U.S. model treaty also provides that each country will collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. The proposed treaty does not contain such a collection provision.

Article 26. (Diplomatic agents and consular officers)

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. Because the saving clause does not apply to Chinese taxes at all, U.S. diplomats who are considered Chinese residents will not be subject to Chinese tax on their diplomatic salaries. Because the saving clause does not apply to U.S. taxes under this article in the case of U.S. residents (who are not U.S. citizens), Chinese diplomats who are considered U.S. residents similarly will not be subject to U.S. tax on their diplomatic salaries.

Article 27. (Entry into force)

The countries are to notify each other in writing, through diplomatic channels, upon the completion of their respective legal procedures to bring the proposed treaty into force. The proposed treaty and proposed protocol will enter into force on the 30th day after the latter of the notifications.

These entry-into-force rules differ from those of the U.S. model treaty which require the countries to exchange instruments of ratification as soon as possible and provide for entry into force upon that exchange.

The proposed treaty and protocol will be effective for income derived in taxable years beginning on or after the January 1st next following the date on which the treaty and protocol enter into force.

Article 28. (Termination)

This proposed treaty will remain in force indefinitely, but either country may terminate it by giving notice in writing through diplomatic channels on or before June 30th in any calendar year after five years from the date on which the treaty enters into force. If a termination occurs, it will be effective with respect to income derived during taxable years beginning on or after the January 1st of the year following that in which the notice of termination is given.

Protocol

At the signing of the proposed treaty on April 30, 1984, a proposed protocol modifying the proposed treaty also was signed. The protocol's provisions, which are discussed below, form an integral part of the proposed treaty.

Paragraph 1. (Scope)

The proposed protocol provides that the treaty does not restrict any tax benefits accorded by the internal laws of, or by an agreement between, the two countries. Thus, the treaty will apply only where it benefits taxpayers. This is a standard U.S. tax treaty provision.

Paragraph 2. (Saving clause)

The proposed protocol adds a "saving clause" to the proposed treaty. Under this clause, the United States reserves the right to tax its citizens, notwithstanding any provision of the treaty. By reason of the saving clause, the United States will continue to tax its citizens who are residents of China as if the treaty were not in force. Under the saving clause, the United States also reserves the right to tax its residents who are not U.S. citizens as if the treaty were not in force, except where this taxation would be inconsistent with certain provisions of the articles dealing with related persons (Article 8), pensions (Article 17), government service (Article 18), teachers and researchers (Article 19), students and trainees (Article 20), double taxation (Article 22), nondiscrimination (Article 23), mutual agreement procedures (Article 24), and diplomatic agents and consular officials (Article 26). For purposes of the treaty (and, thus, for purposes of the saving clause), "residents" include corporations and other entities as well as individuals (Article 4).

The saving clause contained in the proposed protocol differs in certain respects from that contained in the U.S. model treaty and those found in most recent U.S. income tax treaties. Under the U.S. model treaty, both countries generally reserve the right to tax their citizens and residents as if the treaty had not come into effect; under the proposed protocol, only the United States does. Under the U.S. model treaty, there are several exceptions to the rule that a country may tax its citizens notwithstanding any provision of the treaty. The principal exceptions involve the benefits conferred under the treaty with respect to pensions, the foreign tax credit, and nondiscrimination. Under the proposed protocol, the United States reserves the right to tax its citizens without exception. The U.S. model also contains certain exceptions to the saving clause for U.S. residents who are neither U.S. citizens nor have U.S. immigrant status (for example, an exception covering the benefits conferred by the students and trainees article). Similar exceptions are contained in the protocol, but they generally apply to all

U.S. residents who are not U.S. citizens, even those with U.S. immigrant status. Under section 877 of the Code, a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate, or gift taxes will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship; the saving clause of the U.S. model specifically reserves the United States' right to tax former citizens. The saving clause provided in the proposed protocol does not. (However, even absent a specific provision, the Internal Revenue Service takes the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).)

Paragraph 3. (U.S. social security, personal holding company, and accumulated earnings taxes)

The proposed protocol provides that the United States generally may impose its social security, personal holding company, and accumulated earnings taxes notwithstanding any provision of the treaty. However, in a manner similar to certain other U.S. tax treaties, the proposed protocol limits the right of the United States to impose its personal holding company and accumulated earnings taxes with respect to certain companies of the other country. The protocol exempts a Chinese company from the personal holding company and accumulated earnings taxes during a taxable year if, during that taxable year, the company is wholly owned, directly or indirectly, either by one or more individuals who are residents of China (and who are not citizens of the United States) or by the Government of China or any wholly owned agency of that government. In addition, a Chinese company is subject to the accumulated earnings tax only with respect to income from sources within the United States (Treas. Reg. sec. 1.532-1(c)).

Paragraph 4. (Treaty definition of "person")

The proposed protocol amends the proposed treaty's definition of "person" (Article 3) to include, as the U.S. model's definition does, an estate or trust.

Paragraph 5. ("Tie-breaker" rules)

In assigning (under Article 4) a single country of residence for treaty purposes to an otherwise dual residence individual, the protocol states that the competent authorities of the two countries are to be guided by the "tie-breaker" rules of the U.S. model income tax treaty between developed and developing countries. This provision is discussed in greater detail under Article 4 above.

Paragraph 6. (Reduction of royalty withholding tax)

In general, Article 11 of the proposed treaty limits the tax that the source country may impose on royalties paid to a resident of the other country to 10 percent of the gross amount of the royalties. In the case of royalties paid for the rental of industrial, commercial, or scientific equipment, the proposed protocol provides that the tax allowed under the treaty is to be imposed on 70 percent of the gross amount of the royalties only. The effect of this protocol provision is to reduce to seven percent the maximum source country tax on these types of royalties. This provision is discussed further under Article 11 above.

Paragraph 7. (Limitation on benefits)

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and China as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as "treaty shopping." Unde· certain circumstances, and without appropriate safeguards, the nonresident is able to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third country resident to repatriate funds to that third-country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed protocol contains a provision intended to prevent third-country companies that are not bona fide residents of the United States or China from using the treaty to secure certain treaty benefits. The protocol provides that the competent authorities of the United States and China may through consultation deny the benefits of the dividend, interest, and royalty articles (Articles 9, 10, and 11) to a company of a third country if the company becomes a resident of one of the countries for the principal purpose of enjoying benefits under the treaty. The principal benefits provided under the dividend, interest, and royalty articles are reduced source country withholding tax rates.

This anti-treaty shopping provision is much less detailed than that of the U.S. model treaty and those of most recent U.S. income tax treaties. It is considerably less strict than the anti-treaty shopping provision of the U.S. model.

Paragraph 8. (Existing shipping and aircraft tax agreement)

An agreement between the United States and the People's Republic of China governing the taxation of shipping and aircraft income was signed on March 5, 1982, and is currently in force. The proposed protocol makes clear that the proposed treaty will not alter the tax rules for shipping and aircraft income set forth in that prior agreement.

Exchange of Notes

At the signing of the proposed treaty and protocol, notes were exchanged dealing with the issue of "tax sparing" credits.

In the notes, the United States and China agreed that a tax sparing credit would not be included in the proposed treaty's double taxation relief article (Article 22) at the present time. However, the countries further agreed that the proposed treaty would be promptly amended to incorporate a tax sparing credit provision in the event that the United States amended its laws concerning the provision of tax sparing credits, or the United States reached agreement on the provision of a tax sparing credit with any other country.

This provision reflects the desire of China and other developing countries to have the United States adopt a tax sparing credit. Many developed countries provide a tax sparing credit in order to avoid what, in the view of some, is a conflict with the foreign investment incentive policies of developing countries. A tax sparing credit is an income tax credit provided by a country (typically a developed country) against its own tax on income from a developing country. The credit equals the full amount of the developing country's nominal tax on the income, notwithstanding the developing country's reduction or elimination of the tax as part of an investment incentive program. Many developing countries, for example, provide "tax holidays" to residents of other countries who invest in the developing country. Generally, under these tax holidays, the developing countries forego tax on the profits from the foreign-owned business for a period of time. Absent a tax sparing credit, those profits typically would be taxed in full by the country of residence of the business' foreign owner upon repatriation in dividend form. The United States has declined to give tax sparing credits.

This provision of the protocol is similar to, but goes somewhat beyond, provisions included in certain other U.S. income tax treaties with developing countries. The provisions in the other treaties do not make explicit reference to a tax sparing credit and do not include a specific promise by the United States to allow such a credit upon allowing it to another country. Instead, they commit the United States to resuming discussions, when circumstances permit, with a view to incorporating provisions in the treaty that will minimize interference with incentives offered by the other country and will be consistent with U.S. income tax policy vis a vis other developing countries.

○